No. 80-1364

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In the Supreme Court of the United States

OCTOBER TERM, 1980

JAMES ISKE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The principal questions presented in this federal income tax case are whether the Commissioner properly determined the amount of capital gain that petitioner was required to recognize on the sale of easements across his property, whether certain legal expenses incurred by petitioner in connection with this award were adjustments to basis rather than deductions against ordinary income, and whether petitioner's sales of dirt, sand and gravel gave rise to ordinary income subject to depletion rather than capital gains.

The pertinent facts may be summarized as follows: In 1967, the Omaha Public Power District (OPPD) instituted two eminent domain proceedings in the Nebraska state courts to acquire right-of-way easements across two tracts of land owned by petitioner. The easements burdened only a small portion of each tract. Petitioner was ultimately

awarded $185,000 in damages and legal fees, plus interest (Pet. App. 3, 5).[1] On audit, the Commissioner of Internal Revenue determined that petitioner should report capital gain on these sales to the extent that the amounts received exceeded his basis in those portions of the tracts actually burdened by the easement. The Commissioner rejected petitioner's claims that he had no gain because the condemnation awards did not exceed his total basis in the tracts, and that the interest on the condemnation proceeds was exempt from taxation as interest on obligations of a state or its political subdivisions under Section 103 of the Internal Revenue Code of 1954 (26 U.S.C.).

In 1970 petitioner granted Hartford Sand and Gravel Company (Hartford) an option to purchase up to 200,000 tons of various minerals from his land at a fixed price per ton. No minimum purchases were required, and the agreement was to terminate on June 1, 1971. On audit, the Commissioner determined that the sales gave rise to ordinary income subject to depletion allowances, and not capital gains (Pet. App. 7-8).

In this proceeding brought by petitioner in the Tax Court for redetermination of the ensuing deficiency, the Tax Court upheld the Commissioner's determinations in every respect (Pet. App. 1-19). The court of appeals affirmed on the basis of the Tax Court's opinion (Pet. App. 20-21).

1. Petitioner argues (Pet. 3-4, 6) that gain on the sale of the easements should be recognized only to the extent the amount realized exceeds his basis in the tracts of land, despite the fact that the easements burdened only a small portion of those tracts. Treasury Regulations on Income Tax (1954 Code), Section 1.61-6(a) (26 C.F.R.), provides,

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[1]See *Iske* v. *Omaha Public Power District*, 185 Neb. 724, 178 N.W. 2d 633 (1970), for proceedings relating to the larger tract condemned.

however, that where part of a taxpayer's property is sold, only that portion of the taxpayer's basis actually allocable to the portion sold, rather than his basis in the entire property, is relevant for determining gain or loss.

The granting of an easement is such a partial sale. Accordingly, the decision below correctly held that petitioner had to recognize gain to the extent the amount realized on the sale exceeded that portion of his basis that was allocable to the property actually burdened by the easement. Cf. *Byram* v. *Commissioner*, 555 F. 2d 1234 (5th Cir. 1977); *Fasken* v. *Commissioner*, 71 T.C. 650 (1979).

Petitioner cites (Pet. 6) I.T. 2621, XI-1 Cum. Bull. 67 (1932), for the proposition that he need recognize no gain until the amount realized exceeds his basis in the entire property. That ruling, without mention of possible allocation, computed gain on the sale of an easement as the amount by which the sales proceeds exceeded taxpayer's basis in the entire tract.

But I.T. 2621 is no longer authoritative because it was declared obsolete in 1968 in Rev. Rul. 68-661, 1968-2 Cum. Bull. 607. Although the revocation was not explicitly made retroactive, the ground for the revocation was that the ruling was no longer viable in light of the 1954 Code and the Regulations issued thereunder. Furthermore, I.T. 2621 is also inconsistent with later authority, including *Blum* v. *Commissioner*, 5 T.C. 702 (1945); *Inaja Land Co.* v. *Commissioner*, 9 T.C. 727 (1947); Rev. Rul. 54-575, 1954-2 Cum. Bull. 145, and Rev. Rul. 59-121, 1959-1 Cum. Bull. 212, and was thus of doubtful validity long before its revocation in 1968. At all events, notwithstanding his claim to the contrary (Pet. 6), petitioner has failed to show that he

was subject to treatment that was not imposed upon other similarly-situated taxpayers.[2]

Petitioner further argues (Pet. 7) that a portion of the legal expenses he incurred during the condemnation proceedings should be deductible as an ordinary and necessary expense. But it is well settled that legal expenses incurred in defending title to property or in establishing the right to a higher condemnation award are capital in nature. *Madden* v. *Commissioner*, 514 F. 2d 1149 (9th Cir. 1975); *Casalina Corp.* v. *Commissioner*, 60 T.C. 694 (1973), aff'd per curiam, 511 F. 2d 1162 (4th Cir. 1975); Treasury Regulations on Income Tax (1954 Code), Section 1.212-1(k) (26 C.F.R.). Petitioner now argues for the first time that a portion of the legal expenses was incurred in establishing his right to the interest on the increased award. Apart from the fact that he never raised this argument below, it has no merit. The judicial proceedings were not to establish petitioner's right to interest, which accrues as a matter of statute (Neb. Rev. Stat. § 76-711 (Supp. 1980)) if the amount awarded exceeds the amount deposited in the county court by the condemnor. To the contrary, the judicial proceeding was to establish petitioner's right to additional condemnation proceeds.

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[2]Petitioner further argues (Pet. 6-7) that the courts below erred in not treating the $25,000 released to him by the county court in 1968 as income received in that year. But petitioner failed to raise this argument in either the Tax Court or the court of appeals. It is not properly before this Court.

At all events, petitioner failed to show that the award exceeded his basis in the property at that time. Petitioner's basis in that tract was $7,315, plus whatever portion of the $50,000 in legal and witness fees that had been incurred prior to the release of the $25,000 (Pet. App. 3, 6). The record is silent as to what these amounts were. Petitioner was reimbursed for some of those expenses in 1970 (Pet. App. 3).

2. Petitioner also contends (Pet. 7) that interest received pursuant to the condemnation proceedings should be excluded from gross income under Section 103 of the Internal Revenue Code, which excludes from gross income the interest on certain state and municipal obligations. That provision, like its predecessors, was passed to enhance the ability of state and local government to compete in the capital markets. Accordingly, it is well established that it applies only to "obligations" incurred under the governmental borrowing power, not to interest paid pursuant to operation of law. *Helvering* v. *Stockholms Enskilda Bank*, 293 U.S. 84, 87 (1934). Thus, interest payments made pursuant to the condemnation power, not pursuant to the borrowing power, are not payments of interest on "obligations" within the meaning of Section 103, and are not exempt under that Section. *Drew* v. *United States*, 551 F. 2d 85 (5th Cir. 1977); *American National Bank of Austin* v. *United States*, 421 F. 2d 442 (5th Cir. 1970); *Holley* v. *United States*, 124 F. 2d 909 (6th Cir. 1942); *United States Trust Co. of New York* v. *Anderson*, 65 F. 2d 575 (2d Cir. 1933); *Fox* v. *United States*, 397 F. 2d 119 (8th Cir. 1968); *Williams Land Co.* v. *United States*, 31 F. Supp. 154 (Ct. Cl. 1940).

3. Finally, petitioner contends (Pet. 7) that amounts he received, pursuant to an agreement with a contractor whereby the contractor received the right to extract up to 200,000 tons of minerals at a fixed price for a limited time, were taxable as capital gain rather than ordinary income.

Normally, production income is taxable as ordinary income to the owner of a mineral deposit, who can then recoup his capital investment through the depletion allowance authorized by Section 611 of the Internal Revenue Code of 1954, *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308, 312 (1956); *Paragon Coal Co.* v. *Commissioner*,

380 U.S. 624, 626 (1965). Petitioner is the owner of the mineral deposits in question because he retained an "economic interest" in those deposits under the test first enunciated by this Court in *Palmer* v. *Bender*, 287 U.S. 551 (1933), and set forth in Section 1.611-1(b)(1) of the current Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.). Under this test, a taxpayer has a depletable "economic interest" if he has made an initial capital investment in the minerals in place, and has a continuing dependence on production income for a return of his capital.

The transfer of operating rights, without more, does not terminate the transferor's "economic interest" in the minerals in place (and hence is not a capital transaction), whether the transfer is made in consideration of payments dependent upon extraction or paid in a lump sum. See, *e.g.*, *Helvering* v. *Twin Bell Syndicate*, 293 U.S. 312 (1934); *Burnet* v. *Harmel*, 287 U.S. 103 (1932); *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25 (1946). Thus, royalties in a fixed amount per unit of minerals removed are ordinary income, not capital gains, to a transferor of operating rights. *Bankers Coal Co.* v. *Burnet*, 287 U.S. 308 (1932). See also *Rabiner* v. *Bacon*, 373 F. 2d 537 (8th Cir. 1967); *Hartman Tobacco Co.* v. *United States*, 471 F. 2d 1327 (2d Cir. 1973); *Laudenslager* v. *Commissioner*, 305 F. 2d 686 (3d Cir. 1962), cert. denied, 371 U.S. 947 (1963); *Oliver* v. *United States*, 408 F. 2d 769 (4th Cir. 1969); *Wood* v. *United States*, 377 F. 2d 300 (5th Cir.), cert. denied, 389 U.S. 977 (1967); *Gitzinger* v. *United States*, 404 F. 2d 191 (6th Cir. 1968); *Freund* v. *United States*, 367 F. 2d 776 (7th Cir. 1966); *Alkire* v. *Riddell*, 397 F. 2d 779 (9th Cir. 1968); *United States* v. *White*, 401 F. 2d 610 (10th Cir. 1968). But cf. *Linehan* v. *Commissioner*, 297 F. 2d 276 (1st Cir. 1961).

Here, petitioner retained his interest in the minerals in place. Hartford had no obligation to purchase any minimum amount of minerals and merely paid a fixed price per ton for those minerals it chose to extract during the term of the contract. It is therefore plain that the royalties petitioner received were taxable as ordinary income and not capital gain.[3]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

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[3]Petitioner also challenges (Pet. 7) the court of appeals' denial of a stay pending his appeal. That action was fully in accord with Section 7485 of the Internal Revenue Code, which provides that assessment or collection of the deficiency determined by the Tax Court shall be stayed only if the taxpayer files a timely bond, and petitioner filed no such bond.

Moreover, this Court has repeatedly rejected petitioner's argument (Pet. 8) that he was denied due process because he was required to carry the burden of proof. See, *e.g.*, *Welch* v. *Helvering*, 290 U.S. 111, 115 (1933); *New Colonial Co.* v. *Helvering*, 292 U.S. 435, 440 (1934). See also Rules of Practice and Procedure of the United States Tax Court (Jan. 1, 1974), Rule 142(a).